The Financial Performance Of Foreign Bank Subsidiaries

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INTRODUCTION

Multinational Banks (MNBs) expand their operations abroad by establishing subsidiaries and branches or by taking over established foreign banks. The main motivation of bank's internationalization is improvement of the profitability through their foreign subsidiaries and branches. In this way, examination of the performance of U.S. banking companies indicates that a greater part of that performance can be allotted to their foreign subsidiaries activities.In the United Kingdom, Barclays bank has made recently £ 2.41 billion among their profits from its foreign acquisitions, specially from its takeover of North American bank, Lehman Brothers. Bank's foreign subsidiaries have brought and continue to bring important contribution in the parent-bank's whole performance.

In theory, the performance of bank foreign subsidiaries can be influenced both by the economic conditions of countries and by the parent bank's organisational characteristics. Thus, foreign banks subsidiaries could be liquidated if their parent banks experience problems on their own and decide to close some of their subsidiaries. For example, Havrylchyk and Jurzyk (2006) note that the withdrawal of the Dresdner Bank from Romania and Czech Republic, which seemed to be linked to the problems of the Dresdner Bank at the headquarters. According to De Haas and Naaborg (2005), the multinational banks' top managers recognize that they grant more interest to the subsidiary companies that has a potential high return. They support that sometimes, bank subsidiaries, even profitable, could be closed in order to reallocate capital to more profitable project in another country. Indeed, many authors like Bonin and al. (2005), and Majnoni and al. (2003) studied the performance of foreign banks, but their studies only take in account macroeconomic factors to explain the performance and proceed to a comparison between foreign banks and local banks.

In this paper, we investigate the relationship between the performance of bank foreign subsidiaries and the degree of implication of the parent banks in the organization and the management of their activities abroad. For that, we distinguish between bank subsidiaries majoritarily owned and from bank subsidiaries held in minority by the parent bank. Beyond what was done by those authors, our research proposes to take into account the organizational characteristics which bind the parent banks and their foreign subsidiaries. So, in this paper, we attempt to answer the following important question: Did parent bank's degree of implication in the activities of its foreign subsidiaries help to improve performance abroad ? For that, we empirically study of a sample of 123 foreign banks subsidiaries (with or without majority stake).

RELATED LITERATURE

The banking literature often concludes that bank's foreign subsidiaries performance depends to the economic conjuncture. However, we can note that the management of the entity itself should not be relegated to the second plan.

❁Economic And Financial Factors : A survey of the literature shows that the foreign bank performance is affected by factors like the economic and financial environment. Among these factors, one can quote the growth rate of gross domestic product (GDP), monetary market rate, inflation rate and foreign exchange rate. In fact, according to **Williams (1998a, 1998b and 2003),** the growth rate of the GDP per capita of the banks' home countries is an indicator of the opportunity costs related to internationalization. The author explains the incentive of the banks originating from countries with low rate of growth of GDP per capita to internationalize more than those resulting from countries with strong rate of growth of GDP per capita. As Williams (1998a and 1998b) asserts, the growth rate of GDP per capita of the home country affects positively and significantly the profitability of the foreign banks established in Australia. In an inflationary context, the banking costs generally follow a bullish tendency, even if authors like **Awdeh (2005)** defend that inflation does not have really an effect on the profitability measured by return on equity (ROE) of foreign

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banks exerting in Lebanon. In the same way, the author stresses that the level of inflation affects more than the return on assets (ROA) of Lebanese banks than foreign banks in Lebanon. In eastern and central European countries, foreign multinational banks adopt two modes of establishment: the repurchase of local banks and ex-nihilo creations. In this area of Europe, recent works show that the banks created ex-nihilo see their ROA increasing in a period of economic recession and to weaken in period of economic revival **(Havrylchyk and Jurzyk, 2006)**. This paradoxical result can be explained on the one hand, by the high interest rates applied when the economic situation is morose and on the other hand, by the financial support of the parent bank. In addition, the authors maintain the existence of a positive relation between inflation and the profitability of foreign banks' branches, but this factor does not have impact on the profitability of the local banks.

❁**The Parent-Bank's Implication In The Management Of Its Subsidiaries Abroad** : Beyond macroeconomic factors, the bank subsidiary's performance can be affected by the number of years the subsidiary was under foreign control, the style of management founded by the foreign owners and the type of initial investment **(Majnoni and *al.* 2003)**. Indeed, return on asset (ROA) increases during the first post-acquisition years even if the style of management founded in these banks does not concretize truly of advantages in terms of profitability. The best performance by the foreign banks comes from their capacity to propose to their customers, panoply of new financial services, contrary to the domestic banks which offer only less innovated traditional products. **Havrylchyk and Jurzyk (2006)** state that banks created *ex-nihilo* have a higher return on assets than domestic banks. In the same order of idea, **Demirgüç-Kunt and Huizinga (1999)** support that the presence of foreign investors in bank capital is a key signal in the bank's profitability. The percentage of the capital held by the parent bank has a positive and significant effect on the return on equity (ROE) of foreign banks established in Lebanon, even if the domestic banks and the foreign banks have a similar ROA: the fact of passing under foreign control does not improve the return on assets of the repurchased Lebanese banks (Awdeh. 2005).

A bank seeking to dominate its competitors for a given period must have a high profit and evolve in a sector of great attractivity. This condition on obtaining a durable competitive advantage rests on a "good financial health" of the bank. One can then state that all the large banks face competition in the same way because they release from high and comparable profits. But this thesis was refuted by the strategic management through the following question: why the companies of a same industry are neither efficient, nor high return at the same degree? Resource-based theory **(Barney, 1991)**, on an organisational explanation, makes possible to answer to that question. Company's internal characteristics like organizational capabilities enable to understand why the firms of the same sector have neither the same performance, nor same effectiveness. In fact, concerning banks, they have different and heterogeneous resources which constitute their main sources of durable competitive advantages. According to **Merrett (2002. p. 391),** *"Transfers of expatriates into Australian banks and the movement of local bankers to foreign employers within Australia, fostered a cross-fertilization of information and know-how that the banks could then transfer abroad*". During their stay abroad, expatriates acquire new knowledge and know-how which the parent bank will be able to exploit once these expatriates turn over in their home country. Some multinational groups exploit competencies of the leaders repatriated by implying them in the management of their old foreign subsidiary or branch companies, even after they were promised with new responsibilities. Ultimately, human resources make it possible for the parent bank to increase its knowledge production.

The distance between the home country and the host country can be at the origin of the agency problems between the parent bank and its entities abroad, and beyond. It can influence the performance of the subsidiary companies. Thus, more the distance increases, more the control mechanisms weaken, allowing for instance, subsidiary's manager to engage his bank in too risky activities, hoping to obtain a very high profitability **(Deng and Elyasiani, 2005)**. As **Berger and DeYoung (2001)** reported, the management of a multinational bank can prove to be ineffective insofar as the the head office's managers always do not have necessary competencies to control the activities abroad. No technological revolution still made it possible to replace expertise and skills of people, which permit him to keep a personalized relationship with local customers. This specific knowledge is difficult to quantify and to transmit to the head office because of distance, concerns, for example, financial information on the customers or some information on local economic environment.

DATA AND METHODOLOGY

The data measuring ROA and ROE were derived from Bankers' almanac database. It is about accounting data relating to the bank subsidiary abroad. To collect them, the researcher first constituted a sample of subsidiary companies with or without majority stake. Firstly, information was obtained (balance sheet, structure of property, profitability ratios) of 210 subsidiaries. Then, a cleaning was done in order to keep only the banks for which data were available over the period 2001 to 2005. Finally, the sample's size is about 123 bank subsidiaries for which, we computed the average data for the 2001 to 2005 interval.

Table 1 summarizes the descriptive statistics (average, median, standard deviation) of different variables used in the regressions and appendices 1 and 2 respectively present the definitions of the variables and the coefficients of correlation. We adopted the following econometric specification:

$$\mathbf{ROE(ROA)}_i = \alpha_0 + \alpha_1\mathbf{Own}_i + \alpha_2\mathbf{Exp}_i + \alpha_3\mathbf{Dist}_i + \alpha_4\mathbf{Sec}_i + \alpha_5\mathbf{Fin}_i + \alpha_6\mathbf{Nint}_i + \varepsilon_i$$

Where:

i = 1 to N, N = number of bank subsidiaries, α_1.....α_6 parameters representative of the weight of each independent variable on the dependent variable; α_0 is the constant. For more details on variables, see Appendix 1.

We use the regression above to estimate the dependent variables, ROA and ROE, by the same variables (see Appendix 1). For the overall sample, the method of White is used to correct the t of Student's heteroscedasticity, what makes it possible to obtain standard deviations which are consistent (see columns II and IV of table 2). We also divided the sample into two groups: subsidiaries majoritarily owned and subsidiaries minoritarily owned by introducing into the model, a dummy variable "form", equal to 1 if the capital is held mainly by a foreign bank, equal to 0 if not.

Table 1: Descriptive Statistics

	Overall Sample (123)		Subsidiaries Majoritarily Owned (93)		Subsidiaries Minority Owned (30)	
	Mean	Standard deviation	Mean	Standard deviation	Mean	Standard deviation
Return on equity	0.099	0.248	0.126	0.142	0.014	0.431
Return on assets	0.010	0.017	0.012	0.015	0.004	0.021
Ownership structure (Own)	0.718	0.331	0.897	0.178	0.219	0.140
Expatriates presence (Exp)	0.918	0.274	0.967	0.177	0.766	0.430
Distance (Dist)	7.552	1.192	7.441	1.184	7.895	1.167
Securities investments to asset ratio (Sec)	0.178	0.178	0.180	0.175	0.173	0.191
Net financial interest to asset ratio (Fin)	0.029	0.022	0.028	0.021	0.331	0.027
Noninterest expenditure to asset ratio (Nint)	0.053	0.050	0.048	0.037	0.066	0.077

Number of bank observations in parentheses

RESULTS

In this section, we examine the results for the whole sample. We find that ownership *"means the share of the capital held by the parent bank"* affects the financial performance (see Table 2 for the significance of the tests). In fact, the ROE and the ROA of the bank subsidiaries are positively affected by the presence of foreign banks in their shareholding. Therefore, according to the level of participation in the capital, the parent bank is able to reorganize them with the aim to make more of these subsidiaries more profitable. Concerning ROA, the findings corroborate those of Bonin and al (2005): *"Foreign Bank Subsidiaries Acquire A Profitability Which Doubles Those Of Banks Under State Control And Those Of Private Banks"*. The parent bank contributes to improve the operating margin and then allows a better assets turn over of the subsidiaries. However, the author does not confirm the conclusions of Chmielewski and Krzesniak (2003), which stipulate that the ROA of the Poland banks is negatively affected by the percentage of the capital held by foreign banks. Furthermore, our research shows a positive relationship between the ownership and the bank subsidiaries ROA, corroborating the results of Awdeh (2005) on data of foreign banks

Table 2: Results For Overall Sample

	Return on equity			Return on assets		
	(I)		(II)	(III)		(IV)
Ownership structure	0.125[c] (1.79)	0.107[c] (1.79)	0.107[b] (1.96)	0.010[b] (2.14)	0.012[a] (2.72)	0.012[a] (3.21)
Expatriates presence	-0.037 (-0.46)	-0.033 (-0.48)	-0.033 (-0.41)	0.000 (0.17)	-0.000 (-0.10)	-0.000 (-0.13)
Distance	-0.012 (-0.69)	-0.007 (-0.47)	-0.007 (-0.56)	0.002[b] (2.05)	0.001 (1.61)	0.001[c] (1.76)
Securities investments to asset ratio	-0.455[a] (-3.79)	-0.331[a] (-3.20)	-0.331[b] (-1.99)	-0.027[a] (-3.20)	-0.017[b] (-2.26)	-0.017 (-1.61)
Net financial interest to asset ratio	-	3.762[a] (4.05)	3.762[b] (2.10)	-	0.356[a] (5.16)	0.356[a] (3.09)
Noninterest expenditure to asset ratio	-	-2.796[a] (-7.00)	-2.796[a] (-2.33)	-	-0.130[a] (-4.40)	-0.130[b] (-2.01)
Constant	0.220 (1.32)	0.205 (1.47)	0.205 (1.37)	-0.012 (-1.09)	-0.012 (-1.21)	-0.012 (-1.12)
R^2	0.132	0.398	0.126	0.32		

[a]1% level, [b]5% level, [c]10% level

established in Lebanon.

On financial markets, stocks and bonds form the main transferable securities that are daily traded. Table 1 saw that on an average, the bank subsidiaries invest 17.8% of their assets there. The detention of these securities is mainly justified by the search of profits or capital gains, although this investment involves very high risk. Does this strategy of investment have consequences on the performance of bank subsidiaries? According to our results, the answer to this question is affirmative. Indeed, investments in the stocks and bonds affect negatively the ROA and the ROE of the bank subsidiaries abroad.

But this result is to be moderated because by distinguishing the subsidiaries majoritarily owned on a side and the subsidiaries minoritarily (see table 3), we observe that it is the performance of subsidiaries majority owned which is negatively and significantly affected by the investment in the stock exchange. The intervention on the financial markets requires expertise and know-how that do not have the majority of these banks. In fact, the low capital level held by the multinational large banks (22% on average against 88% on average for the group of the subsidiary companies majoritarily held) can justify the fact that these banks were not the object of a transfer of sufficient knowledge with regards to intervention on the financial markets. The study supports the conclusions of Sul (2000) which allots bad performance (ROA and ROE) of the abroad subsidiaries of Korean banks to their lack of experience and the high cost of the capital.

The presence of expatriates into the bank subsidiaries impacts negatively, the two measures of performance (see table 3). We can then conclude that the expatriation always does not play in favour of an improvement of the performance of the banks abroad. If the fact of having qualified and experienced managers within these banks is a pledge of good management, emergence of conflicts of interests can lead to decrease in bank performance. Two main reasons can justify the negative relationship between the presence of expatriates and bank subsidiaries performance abroad:

(1) The fact that the subsidiary companies are created by acquisition is often the heritage of bad performance whose rectification requires new efforts of organization and management to the new executive team. The author joins Peek

Table 3: Results After Separating Sample Into Majority Owned And Minority Owned Subsidiaries

		Own	Exp	Dist	Sec	Fin	Nint	Constant	R^2
Subsidiaries majoritarily owned	Return on equity	-0.001 (-0.02)	-0.129 (-1.54)	0.009 (0.74)	-0.026 (-0.31)	-	-	0.186 (1.22)	0.033
		0.108 (1.30)	-0.134[b] (-1.98)	-0.000 (-0.08)	0.015 (0.19)	2.758[a] (3.89)	-0.321 (-0.69)	0.100 (0.77)	0.139
	Return on assets	-0.003 (-0.39)	-0.006 (-0.75)	0.004[a] (3.46)	-0.004 (-0.48)	-	-	-0.010 (-0.66)	0.133
		0.012 (1.52)	-0.007[a] (-3.65)	0.002[a] (2.64)	0.003 (0.49)	0.338[a] (3.83)	0.026 (0.45)	-0.024[c] (-1.76)	0.315
Subsidiaries minority owned	Return on equity	-0.084 (-0.16)	-0.023 (-0.14)	-0.030 (-0.54)	-1.511[a] (-4.36)	-	-	0.551 (1.22)	0.488
		0.001 (0.01)	0.018 (0.13)	-0.008 (-0.19)	-0.896[a] (2.33)	2.836 (1.01)	-3.424[a] (-3.01)	0.352 (0.99)	0.731
	Return on assets	0.004 (0.15)	0.001 (0.13)	-0.000 (-0.24)	-0.078[a] (-4.45)	-	-	0.021 (0.93)	0.484
		0.006 (0.52)	0.002 (0.45)	-0.000 (-0.15)	-0.044[b] (-2.22)	0.234 (1.53)	-0.174[a] (-3.37)	0.014 (0.82)	0.735

[a]1% level, [b]5% level, [c]10% level

and al (1999) who found that the current bank subsidiary profitability often results from its situation of before acquisition.

(2) The introduction of new management can be at the origin of problems of agency. Expatriates, principal vectors of knowledge transmission the bank subsidiaries are confronted abroad, sometimes with cultural conflicts that block, according to Kogut and Singh (1988), decision makings within the subsidiaries. To be able to transfer values to the entities abroad, parent bank engages in a *"Rupture With Established Routines"* as these routines cannot coexist with the new organisational practices.

We find that the distance between home country and host country affects positively the ROA of the majoritarily owned subsidiaries. Albeit opposite with the awaited sign (see appendix 2), this result attests that the technological advancements make it possible to attenuate and to even remove the negative consequences of the distance on the banking performance abroad. Nowadays, the technological tools facilitate capitalization and the diffusion of knowledge in the bank and enable to reduce the costs of collection of information (Deng and Elyasiani. 2005). Their use makes it possible to combine knowledge of the various entities of the bank without passing by the traditional hierarchical system, which results in a profit of effectiveness in terms of management, which can affect the financial performance. The technological tools make it possible to transmit to the structures established abroad, real-time information. All the great banking groups have Websites whose first role is certainly to make known the products and the banking services, but the Internet also became a support of intra-bank communication, by which the bank subsidiaries exchange knowledge, organisational and management practices.

The author introduced variables "Fin" and "Nint" into the model to control the effect of the financial characteristics. The results of the whole sample show, for this purpose, that the "net financial interest" and the "Non-interest expenditure" influence in opposite direction the ROE and the ROA. However, by dividing the sample, it is noted that there is a certain nuance for the impact of these two variables on the performance. Indeed, only the ROA and the ROE of the subsidiaries majoritarily owned are positively and significantly affected by the "net financial interest" ,while the performance of the subsidiaries minoritarily owned is negatively affected by the non-interest expenditure supported.

CONCLUSION

The paper investigates the relationship between subsidiaries as a mode of representation and bank performance abroad. Very often, economic literature relates that multinational banks carry out benefit record these last years. Until now, various researches were restricted to compare the performance of the foreign banks with that of the domestic banks. This research found that this performance depends mainly on the organizational characteristics of the entity established abroad. Thus, in the light of our results, we can conclude that the degree of engagement of the parent bank in the activities of subsidiaries abroad constitutes an explanatory factor of the performance. The study provides answers to the following questions to be able to help the experts of the bank: up to which level of the capital, the parent bank does have it to hold to obtain the performance expected? The percentage of the capital held by the parent bank is a determinant of the performance abroad. It reflects the level of engagement of the head office and especially its capacity to influence the policy of the subsidiary company, which is not without consequence on the performance.

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Appendix 1: Variable Descriptions

Variables	Description	Awaited sign	Data bases
Bank organizational characteristics			
Ownership structure	= 1 if majority owned at 0 otherwise	+	Bankers'almanac
Expatriates presence	= 1 if there is an expatriate as subsidiary's manager at 0 otherwise	+	Bankers'almanac
Distance	= Log distance (en km) home country and host country	-	www.ephemeride.com (distances between cities)
Securities investments to asset ratio	= Amount invested in securities and asset ratio	-	Bankers'almanac
Variables for control			
Net financial interest to asset ratio	= Net financial interest to asset ratio		Bankers'almanac
Noninterest expenditure to asset ratio	= Noninterest expenditure to asset ratio		Bankers'almanac

Appendix 2: Matrix Of Correlation

Variables	Own	Exp	Dist	Sec	Fin	Nint
Own	1					
Exp	0.337	1				
Dist	-0.193	-0.063	1			
Sec	0.067	-0.040	0.042	1		
Fin	-0.221	0.035	0.299	-0.175	1	
Nint	-0.170	0.006	0.237	0.049	0.421	1